How to Avoid the Worst Sector ETFs

Question: Why are there so many ETFs?

Answer: ETF providers tend to make lots of money on each ETF so they create more products to sell.

The large number of ETFs has little to do with serving your best interests. More reliable & proprietary fundamental data, proven in The Journal of Financial Economics, drives our research and analysis of ETF holdings and provides investors with a new source of alpha. We leverage this data to identify three red flags you can use to avoid the worst ETFs:

1. Inadequate Liquidity

This issue is the easiest to avoid, and our advice is simple. Avoid all ETFs with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the ETF and the underlying value of the securities it holds. Plus, low asset levels tend to mean lower volume in the ETF and larger bid-ask spreads.

2. High Fees

ETFs should be cheap, but not all of them are. The first step here is to know what is cheap and expensive.

To ensure you are paying average or below average fees, invest only in ETFs with total annual costs below 0.47%, which is the average total annual costs of the 255 U.S. equity Sector ETFs we cover. The weighted average is lower at 0.28%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows Invesco KBW High Dividend Yield Financial ETF (KBWD) is the most expensive sector ETF and Schwab U.S. REIT ETF (SCHH) is the least expensive. Simplify (VCAR, VPOP) provides two of the most expensive ETFs while Fidelity (FSTA, FNCL, FHLC) ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector ETFs

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
KBWD	Invesco KBW High Dividend Yield Financial ETF	Financials	1.38%
EMLP	First Trust North American Energy Infrastructure Fund	Energy	1.07%
VCAR	Simplify Volt RoboCar Disruption and Tech ETF	Technology	1.06%
VPOP	Simplify Volt Pop Culture Disruption ETF	Technology	1.06%
KOIN	Capital Link NextGen Protocol ETF	Technology	1.06%
Least Expensive			
SCHH	Schwab U.S. REIT ETF	Real Estate	0.08%
USRT	iShares Core U.S. REIT ETF	Real Estate	0.09%
FSTA	Fidelity MSCI Consumer Staples Index ETF	Consumer Non-Cyclicals	0.09%
FNCL	Fidelity MSCI Financials Index ETF	Financials	0.09%
FHLC	Fidelity MSCI Health Care Index ETF	Healthcare	0.09%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] Fidelity MSI Consumer Staples Index ETF (FSTA) is the best ranked sector ETF in Figure 1. FSTA's Attractive Portfolio Management rating and 0.09% total annual cost earns it a Very Attractive rating.[2] iShares U.S. Home Construction ETF (ITB) is the best ranked sector ETF overall. ITB's Attractive Portfolio Management rating and 0.45% total annual cost also earns it a Very Attractive rating.

On the other hand, Schwab U.S. REIT ETF (SCHH) holds poor stocks and earns our Very Unattractive rating, yet has low total annual costs of 0.08%. No matter how cheap an ETF, if it holds bad stocks, its performance will be bad. The quality of an ETF's holdings matters more than its price.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoiding bad ETFs, but it is also the most important because an ETF's performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each sector with the worst holdings or portfolio management ratings.

Figure 2: Sector ETFs with the Worst Holdings

Ticker	Name	Sector	Portfolio Management Rating
PSCM	Invesco S&P Small Cap Materials ETF	Basic Materials	Unattractive
IYC	iShares U.S. Consumer Discretionary ETF	Consumer Cyclicals	Unattractive
IECS	iShares Evolved U.S. Consumer Staples ETF	Consumer Non-cyclicals	Neutral
FENY	Fidelity MSCI Energy Index ETF	Energy	Unattractive
PSCF	Invesco S&P Small Cap Financials ETF	Financials	Unattractive
FBT	First Trust NYSE Arca Biotechnology Index Fund	Healthcare	Unattractive
XAR	State Street SPDR S&P Aerospace & Defense ETF	Industrials	Unattractive
USRT	iShares Core U.S. REIT ETF	Real Estate	Unattractive
WCLD	WisdomTree Cloud Computing Fund	Technology	Unattractive
XTL	State Street SPDR S&P Telecom ETF	Telecom Services	Neutral
PSCU	Invesco S&P Small Cap Utilities & Communication Services	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

iShares (IYC, IECS, USRT) and Invesco (PSCM, PSCF, PSCU) appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

First Trust NYSE Arca Biotechnology Index Fund (FBT) is the worst rated ETF in Figure 2. WisdomTree Cloud Computing Fund (WCLD), State Street SPDR SP&P Aerospace & Defense ETF (XAR), iShares Core U.S. REIT ETF (USRT), and Fidelity MSCI Energy Index ETF (FENY) also earn a Very Unattractive predictive overall rating, which means not only do they hold poor stocks, they charge high total annual costs.

Our overall ratings on ETFs are on our stock ratings of their holdings and the total annual costs of investing in the ETF.

The Danger Within

Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business and finances. Put another way, research on ETF holdings is necessary due diligence because an ETF's performance is only as good as its holdings' performance. Don't just take our word for it, see what Barron's says on this matter.

PERFORMANCE OF ETFs HOLDINGs = PERFORMANCE OF ETF

[1] Three independent studies from respected institutions prove the superiority of our data, models, and ratings. Learn more here.
[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

Analyzing each holding within funds is no small task. Our Robo-Analyst technology enables us to perform this diligence with scale and provide the research needed to fulfill the fiduciary duty of care. More of the biggest names in the financial industry (see At BlackRock, Machines Are Rising Over Managers to Pick Stocks) are now embracing technology to leverage machines in the investment research process. Technology may be the only solution to the dual mandate for research: cut costs and fulfill the fiduciary duty of care. Investors, clients, advisors and analysts deserve the latest in technology to get the diligence required to make prudent investment decisions.

This article originally published on October 22, 2021.

Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, sector, or theme.

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1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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